RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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FEAR: I woke up last night worrying, worrying because I don't know if I made the whole concept of a market bottom clear enough. To put it simply, a market will decline until it reaches the "fear level." This is the level where the *worst fears regarding the future fail to bring out any more important selling.*

And that's the reason why we watch the various indicators which *actually measure* fear (or confidence). When the odd lot shorts, the NYSE short interest ratio, the public shorts, the put-call ratio, etc., signal that stockholders and traders are truly frightened, at that point we can start looking for the bottom.

A corollary of this is that the best bottoms are recorded when the Averages halt their descent and fear *continues to mount.* Then we can say, "Ah, no amount of fear, shock or worry can knock this market down any further. This has got to be the bottom."

The same rationale pertains to **downside non-confirmations.** When we see Industrials or Transports or the A-D ratio or some other important indicators refusing to confirm on the downside, we can say, "The prevailing fear atmosphere is failing to knock this market down across the board. Certain segments are resisting. The market is showing pockets of strength, despite rising fear." That's another indication that the bottom is near or has arrived.

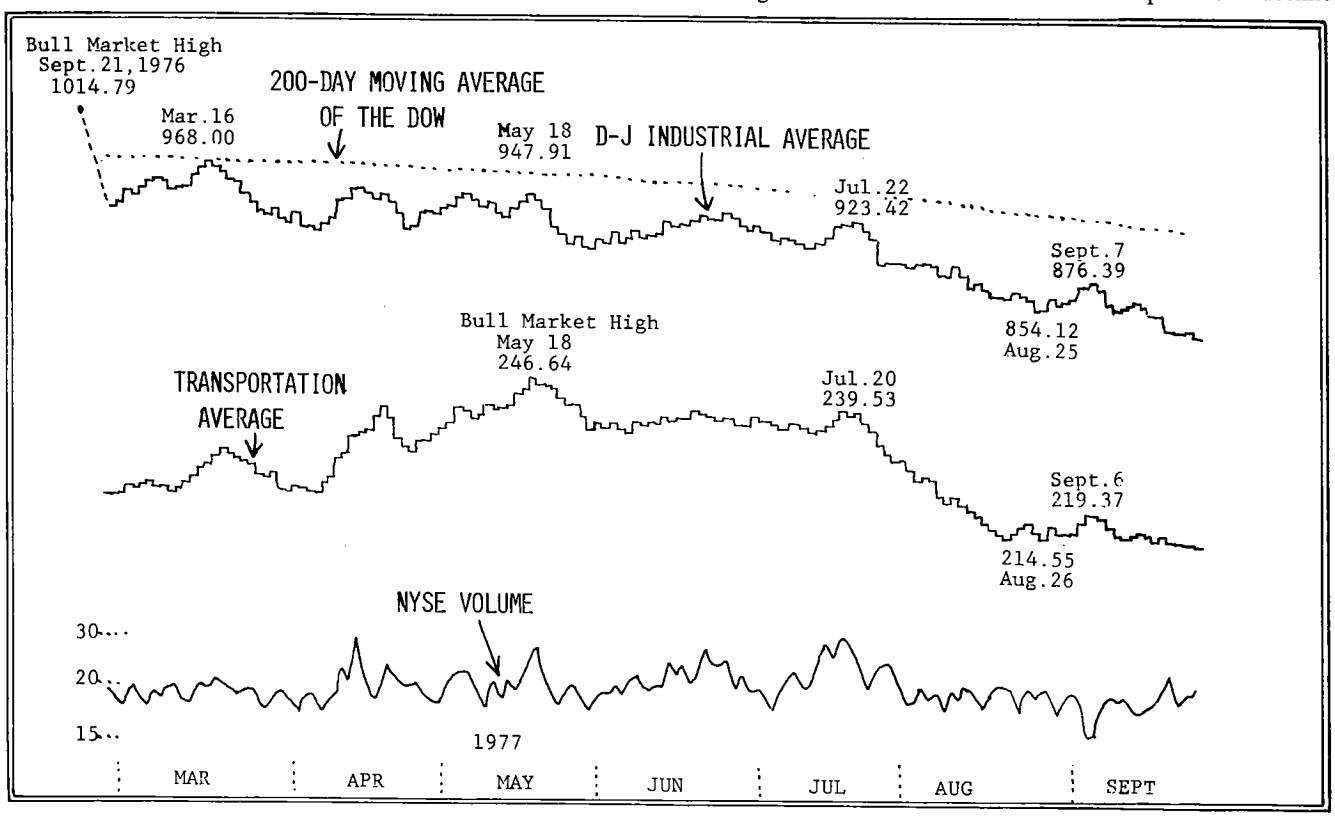
Incidentally, market **panics** (which are usually ushered in by sudden bad news) *end quickly,* because the fear level explodes in a matter of hours. But the kind of market decline we're currently witnessing drags on, it drags on because the *fear level is a long time in building.* As of now, we just haven't reached the real fear quotient. It lies somewhere ahead.

WAITING: With new 1977 lows being recorded last week in the D-J Industrial and Transportation Averages, in the NYSE Composite, in the Standard & Poor's 500 and in the D-J 65 Stock Average, the odds increasingly favor the arrival of a "fully over-sold" condition before this correction breathes its last.

Bull market corrections frequently end in "selling climaxes" (such as we last saw in 1957 and 1962). These climaxes are characterized by heavy volume, plunging stock prices, wild, whipping movements in the Averages and an atmosphere of fear or panic. Obviously I don't know whether the current reaction is going to end in a selling climax, but I am including the above description because I believe a selling climax somewhere ahead is a distinct possibility.

Subscribers should not look at a selling climax as an adverse development. The fact is that some of the best and most profitable bull market advances have had their beginnings in the heavily over-sold bottoms created by classic selling climaxes.

Over the past few weeks I have been watching for indications of a "sold-out" market, a condition created by extraordinarily heavy selling pressure. A sold out market can result from a selling climax or it can result from a persistent decline that



simply "goes too far." An over-sold market is always a function of *investors' fears*, and so far this is the ingredient that has been **missing**. An air of stubborn complacency hangs over Wall Street, this despite a well-advertised drop of 180 points in the Dow. When today's atmosphere of complacency gives way to fear, we will be at or very near the bottom.

I am asked "How far does the Dow have to go before this market becomes oversold?" The answer is that it doesn't work that way. An over-sold condition is created by the action of the great mass of stocks, and theoretically the Dow could hold here or well above 800 and the market could go over-sold. As a matter of fact, I have written that after leading the market down for many months, the Dow (starting in mid-August) began showing superior relative strength to the rest of the market.

At this point I am particularly interested in the action of the **D-J Transportation Average**. Here's the reason: the Transports have **never confirmed** the weakness of the Dow. They have (to put it technically) never violated their 203.85 level of October 12 1976 (the comparable Dow level at that time was 932).

Now this is important: as long as 203.85 is not broken by the Transports, a major downside non-confirmation will be in force. What I personally would love to see is an over-sold market with Transports holding this side of 203.85. Such a situation would lend powerful support to any advance that begins from an over-sold market bottom.

THE MARKET: Perhaps the hardest lesson man has ever had to learn is that he is not the center of his world. To my mind, three tremendous realizations have forced man to face this concept.

The first realization was that God, not man, is the universal intelligence and power. This mind-boggling, awe-inspiring thesis is still resisted by a sizable portion of the world's population. Man, pitiful creature that he is, prefers to believe that all power is his.

The second realization stemmed from the work of Copernicus, a Polish scientist and churchman who later settled in Italy. It was Copernicus who upset the world with his heritical thesis that the sun, not "man's earth," was the center of the solar system. And even worse, Copernicus stated that the planet earth was merely one of many planets in a vast solar system. For his revolutionary concepts, Copernicus faced a steady barrage of threats and sneers.

The third ego-shrinking realization was put forth by Sigmund Freud, a Jewish physician from Vienna, who had been treating nervous diseases and hysteria with various unorthodox methods including hypnotism and cocaine. Freud, in one of the most controversial discoveries in world history, came up with his concept of the unconscious mind. To a protesting and shocked civilization, Freud held that man was motivated (and often ruled) by unconscious forces of which he was unaware (worse, forces that he would even deny).

Thus, for the third time man was shown to be slave (or at least a servant) of his universe, rather than its master. Furthermore man was shown to be less than ruler of his own destiny.

But what has all this to do with the stock market and the investor, the fellow (such as you or I) who merely wants to find the best and most profitable place to put his money? It has everything to do with the investor. But first, let us examine an irony. The irony is that so-called investing is rarely simple or easy–and it is even more rarely profitable.

Look at the history of the nation over the last 10 years. We've had steady inflation, a huge expansion in business and a prodigious advance in land and real estate values. Furthermore, over the last decade we've had the highest rate of return on bonds since the Civil War. Yet how many people do you know who have reaped a fortune in the last 10 years? Even more discouraging, how many do you know who have even kept up with inflation?

But don't be too disheartened. Even professional management has turned in a dismal performance. The median rate of return by professionally managed funds over the past decade was 4.2%. This kind of harsh treatment on the part of the market has led to the new "indexing" fad, the desire by professional fund managers to do "at least as well" as the leading averages.

What has happened, we ask, why can't we at least be masters of our financial fates? And the answer is simple in a way: it is that the world, and specifically the financial world, simply refuses to arrange itself to fit our preconceived notions. The fact is that the stock market, the bond market, the commodity market, the real estate market, none of them stand ready to follow our projections, our silly little trendlines, our plans or our needs.

It's enough to discourage even the stoutest investor. Conceding the Almighty his power, conceding Copernicus his theories and allowing Freud his concepts of the unconscious, can't we poor investors even maintain control over our financial destinies? And the answer is no–but we keep on trying (what else can we do?). In the market, as everywhere else, we try to have an open mind, and we just do the best we can.

Through many years of continuing mistakes, errors and blows to my ego, I've learned the truth of the market adage which states, "***The market can do anything.***" An ignorance of this adage, or the willful ignoring of this adage, has sent thousands of investors (and dozens of market analysts) to their financial graves.

In the end I've had to develop my own system of trying to deal with the markets. The system works like this. I study, I read everything I can get my hands on, I think, sleep and dream about the markets, and then (if I'm lucky or if my intuition is working) I come to an over-all conclusion, a broad concept of what I expect ahead. Once I've worked out what I term my "master plan" for the market, I do two things (and these are critical). The first is, I watch to see whether the stock market, the technical situation, the psychological undertone, all militate in favor of my scenario. And just as important, I watch to see which items appear to militate against my scenario.

In other words, I watch both sides, and I weigh them as impartially as I can. If, at any time, the factors against my scenario seem to be upsetting my basic logic, I stand ready to change my mind and my scenario. But I change very carefully, because I know that the market is always out to make a fool of me (and every other analyst, for that matter). And I know that if my scenario actually comes to pass, I've probably lived through some kind of miracle.

All right, how does all this fit into the current market? It fits in as follows. I've made a number of assumptions, assumptions based on my studies, my theories, my intuition. Here are the most important of those assumptions.

(1) A primary bull market started in late-1974 (following the worst market collapse since the 1930's). That primary bull market is **still in effect.**

(2) At no time since the bull market began in late-1974 have stocks become "over-valued." At present, the P/E ratio for the Dow is 8.6, and the dividend yield on the Dow is 5.3%. Furthermore, the Dow is in that rare, under-valued area which finds it selling below tangible book value.

(3) If this bull market follows all others, there will ultimately be a phase (i.e., the third phase) in which stocks rise beyond reasonable value. This phase will be characterized by great excitement, high volume, and speculative excess.

(4) The bull market completed its first phase in mid-1975. The second phase carried to late-1976 and probably into 1977. Most of 1977 has been typical of the deceptive kind of correction which ends the second phase of a bull market. Since I felt the correction would be costly and deceptive, I advised my subscribers to move "to the sidelines." We have been watching the downside action from a safe distance, with our assets in cash, bills, bonds or the equivalent.

(5) We are now waiting for the termination of the second phase correction. At such time, stocks will be basing and readying themselves for the third phase of the bull market.

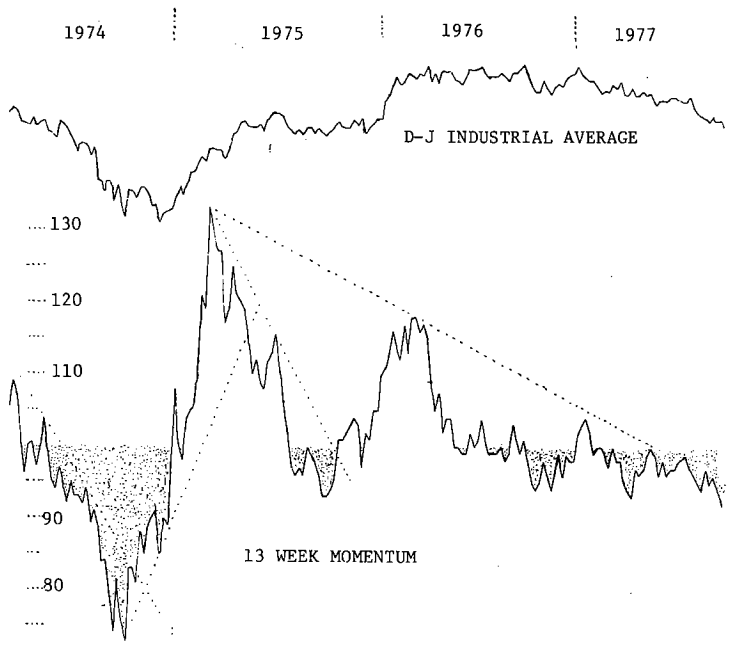
(6) The third or speculative phase of the bull market should be the most profitable one. There is no way of pre-judging how far the third phase will carry or how long it will last. It should, however, take the leading stock market averages to new highs.

(7) A prerequisite, an absolute prerequisite for a major market advance (and particularly for a third phase advance or a series of advances) is a ***WIDE-SPREAD*** CONVICTION THAT SUCH A RISE IS WELL-NIGH IMPOSSIBLE. Just as investors in 1926 refused to believe that 1928 and 1929 could happen, just as investors in 1957 refused to believe in the possibility of 1958 to 1966, investors today must become TOTALLY SKEPTICAL of the possibilities of a major, highly speculative rise to start somewhere ahead.

(8) In my opinion, the 12 month decline in the Dow, the three month decline in the A-D ratio and the collapse in many individual issues is slowly fomenting an atmosphere of discouragement. Certainly, few if any analysts are now talking about a **major** advance to start somewhere in the period ahead.

(9) According to my data, this market has not been thoroughly over-sold since late-1976. A fully over-sold market is a product of fear, discouragement and disgust. I believe this market **must go fully over-sold** if a base can be built for a coming third phase of the bull market. We will see a fully over-sold condition WHEN THE MARKET ITSELF IS READY TO GO FULLY OVER-SOLD, AND NOT BEFORE!

(10) Using my Fibonacci studies, I have made a case for the second phase bottom to appear in October (next month). Whether the market obliges remains to be seen (obviously, the odds are always overwhelmingly against Richard Russell or any other analyst being able to pick a major bottom down to the last month). At any rate, more important than my picking the bottom in October is the probability that a good bottom does lie somewhere ahead. When we hit it, I'm going to say "buy 'em." But I'm not going to say "buy 'em" until I am reasonably convinced that we are at THE bottom.



MOMENTUM: I am including here a chart of the rate of change for the Dow Industrials. This study is often called a momentum study, but *rate of change* is more accurate. What we see here is an index showing the Dow as a percentage of its own price 13 weeks previous. This means that any time the momentum index is above 100 the Dow is above its price of 13 weeks ago, and a figure below 100 indicates that the Dow is below its price of 13 weeks ago.

In my studies of this index, I use three factors: (1) is the index above or below 100, (2) which direction is the index travelling, and (3) how shallow or steep is the angle of ascent (or descent).

The momentum index (MI) is very useful for illustrating the principle of action and reaction (a principle which applies in the stock market just as it does in physics). Note, for instance, that during the 1973-74 crash the MI dropped precipitously to an extremely low reading of 75. The crash in the MI hit bottom in September, 1974, three months **ahead** of the final December low for the Dow.

By the time the Dow hit its historic 577.60 1974 low, the MI had actually changed its direction–to the upside. Then, in a reversal of its collapse action of 1973-74, the MI surged into 1975-76, hitting an extraordinary peak of 136 in March, 1976.

Next a weaker impulse took the MI back to 93–this in September, 1976. Here it was becoming obvious that each new impulse of the MI was smaller and more subdued. The MI was moving towards equilibrium at 100.

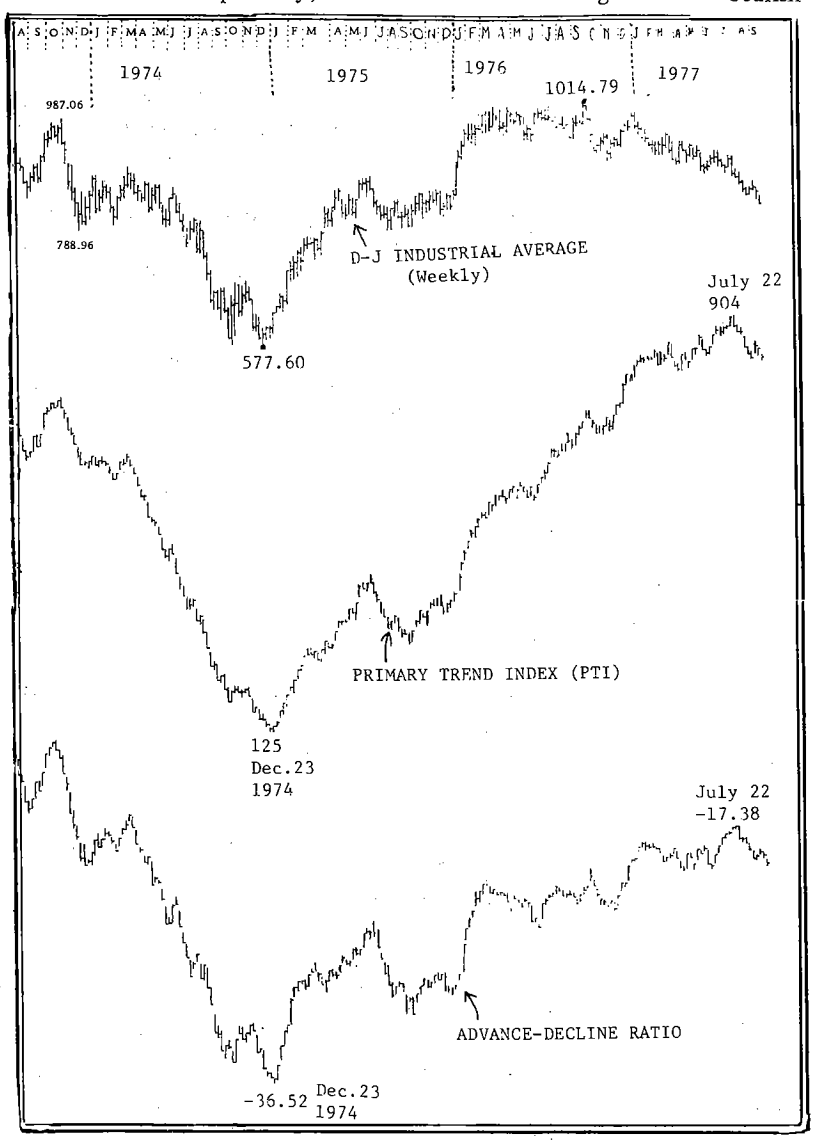
Following a mild reading of 103 in January, 1977, the MI slid to a minor low reading of 93 in April. Next the MI pushed to exactly 100 in May. Note, however, that the MI was *holding below 100 all during 1977*, an indication that the Dow was continuing to decline–but without any increasing downside acceleration.

On the week ending September 23 the MI did something important, something that made me sit up and take notice. On that week it closed at a new three-year low of 90. That meant that the decline in the Dow was beginning to accelerate–to pick up steam. Such action suggests that we are now moving into the final phase of this reaction.

Of particular interest (see chart) is the **long descending trendline** which begins from the early 1975 peak. Over the past few months the MI has been sliding lower, just under the trendline. Sooner or later, the MI is going to turn up and push decisively above the trendline. When that happens, it will be an important signal that the market is reversing bullishly to the upside.

BIG PICTURE: The accompanying chart shows the weekly high, low and closing range of the D-J Industrial Average, the Primary Trend Index and the advance-decline ratio of the NYSE. I want to make some comments about the market from the standpoint of these three indicators.

First, for newer subscribers I should say that the Primary Trend Index (PTI) is my own composite of eight critical averages and indicators. The components of the PTI include the D-J Industrial, Transport, Utility and Bond Averages, the S&P 500 Composite, the most-active stock plurality, the A-D ratio and the high-low plurality. The PTI is plotted daily, but what we see here is the weekly range of the daily figures.



The A-D ratio is the differential of the daily advances and declines, adjusted by dividing the total number of issues traded. This, like the PTI, is a continuous line with each day's new figures added (or subtracted) from the previous total. The A-D ratio portrays the advancing or declining tendency of the majority of NYSE issues. Many analysts now use the A-D ratio as an average, but it most certainly is not a true average.

I have often written that survival in this business is a matter of (intuitively) knowing which indicator to believe and which indicators to "throw out" at any given time. As subscribers over the past 10 or 15 years know, I have probably written more about the A-D ratio than any analyst living today. I was writing about the A-D ratio during the late 1950's and early 1960's at a time when Wall Street didn't know what the Advance-Decline ratio or market breadth was.

Looking at the chart we see one of the most extraordinary periods of divergence (between the Dow and the A-D) in stock market annals. The divergence began in September, 1976 and lasted to July, 1977, a period of 10 months! During most of this period Wall Street's analysts remained bullish because "the market" (as measured by the A-D) was "acting so strong." I distrusted this view, and despite the rising A-D, I turned bearish on the intermediate-term trend in early 1977. I also wrote that in the vast majority of cases, price-breadth divergences in the past have been resolved in favor of the downside.

The A-D ratio hit its high on July 22, 1977, then turned down. This sudden reversal caught Wall Street by surprise, and the results have been costly, to say the least. Over the past few weeks the ranks of the bears have swelled, and, of course, this is the kind of turn in sentiment which will ultimately produce a bottom in the market.

The point I want to raise is that while the Industrials have broken all their lows going back to late-1975, the A-D ratio is nowhere near confirming (as you can see on this chart). In my opinion, this superior long-term strength in the A-D ratio (and the long series of downside non-confirmations) contains long-term bullish implications. But when the market is down and Wall Street is bearish, no one wants to hear about "long-term bullish implications." Nevertheless, I think the overall price-breadth picture is crucial, and it will lend a bullish aura to the final over-sold market bottom.

The PTI led the market down all during 1973-74. Even during the sporadic rallies of that period the PTI was unflagging in its bearish implications. For that reason, I am particularly interested in the steady rise of the PTI right up to its July 22, 1977 peak. The resistance to the downside shown by the PTI is as dramatic as that shown by the A-D ratio.

Conclusion: I take the superior action of the PTI and the A-D ratio (superior to the Dow) as long-term bullish. But the bullish implications will not be seen or noticed now. They will only be seen when this market hits bottom and finally turns up.

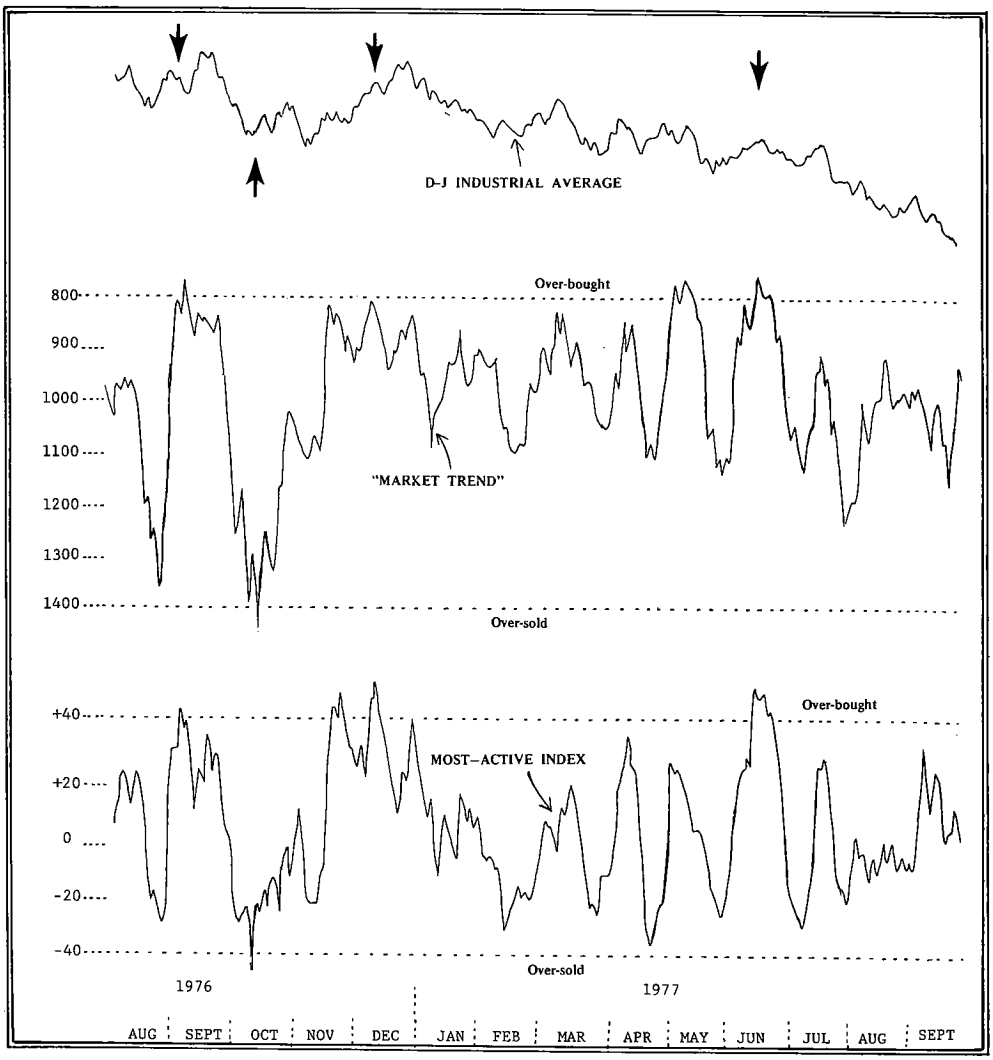


CHART OF THE HOUR: Updated on page 5 is the chart of the "market trend" and the most-actives, two indicators which should be of great help in telling us when this market is over-sold. So far, we just ain't there. Investor's are still "too optimistic" and these two indicators document that statement.

Today's market is declining while investors' sentiment remains hopeful. You don't think they're hopeful. Then why is the most-active index still so high? Yes, they are still wearing rose-colored glasses. What I'd like to see is just the opposite of today's situation. Instead of a market that is falling while investors remain hopeful, what we need is a market that is holding (one that refuses to go lower) even while sentiment is turning blacker.

Somewhere ahead we're going to see that condition. We're going to see the Averages hold while sentiment on Wall Street and Main Street turns so black you can cut the atmosphere with a knife. But for now, the market trend indicator is at approximately 1000–when an over-sold reading would be around 1400. And the most-active index is around plus 2–when an over-sold reading is around minus 45 to minus 50. So–we wait.

COMMENTS: At present there are *only three* Dow stocks above their 200-day moving averages. They are Proctor and Gamble, Texaco and Sears. American Tel. and American Brands are sitting on their MA's. At rare instances all 30 of the Dow stocks sink below their 200-day MA's. When that happens, the market is generally over-sold and in a buying area. We're not there yet.

* *

The current record total of $9.6 billion in stock market debt is overhanging Wall Street. What is so unnerving is the chance of part of this debt being called as prices decline. Neither I nor anyone else has ever seen a market go down with this much debt (margin) outstanding. I look at it this way: for over a year this market has stubbornly refused to go over-sold. When stubborn resistance finally gives way, we often see something dramatic occur. The drama that lies ahead could be a massively over-sold market. There is nothing like margin calls to produce a selling climax.

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To update the study of the three moving averages (MA's) of the Dow, on the week ending September 23 the 50-week MA was 928, the 13-week was 881 and the 4-week was 858. All three MA's were declining, and the negative spread between the 50-week and 13-week was 47 points, biggest spread of the year. Thus selling pressure is increasing and this study says, "on the sidelines." The MA study (simple and fundamental as it is) has served us particularly well in 1977. It has been such an outstanding help because for months (ever since late-1976) the Dow alone was telling the true story, while the other so-called "lead indicators" lagged.

* *

Even the most stubborn hold-out observer must now concede that this market is heading down. Thus early-1977's brave bulls have had to bow to reality. The current thinking seems to be that although the market is sliding, the whole decline "has little or nothing to do with business. It's all psychological, based on Carter, Lance, Burns and the 'baddies' in Washington–plus rising interest rates." To which I say, I'm not at all convinced. A contrary opinion would be that we face a recession or at least a slide in corporate profits. I happen to think that is what we do face, and I'd be willing to bet that the trouble will be visible by December.

* *

I've been talking about values and the fact that the Dow is at only 8.8 times earnings and yielding 5.3%. I've also noted that the Dow is below book value. BUT too many analysts have now picked up this theme. They claim that because stocks are values "they can't really go down much further." The value thesis is very fundamental and it contains long-term bullish implications, but as a short-term timing guide the value concept is useless. Thus, the "stocks are great values here in 1977" concept turned out to be a trap. The contrary opinion was that "stocks are indeed bargains on a historical basis, but they will be even greater bargains before this slide is over!

* *

World business is slowing down. From Germany to Switzerland, from Brazil to Holland, it's slowing. This has meant devaluations so far, and that nasty phrase "competitive devaluations" is

creeping into the language again. Meanwhile, Japan is turning into a fantastic "producing machine." They've got the work ethic, they've got the workers, they've got the will. And most unbelievable of all, they are now moving ahead of the world in technology (with the possible exception of West Germany). All of this spells deflation to me, deflation and probably a long-term trend of lower interest rates. Liquidity is building and business is slowing. That spells a bull market in bonds (notwithstanding the temporary corrections).

SWITCH: Once a gold-bug, always a gold-bug, or at least (as far as I am concerned) always a gold-watcher. With the world's economies slowing down, we face deflation. Now deflation is bearish for gold. That is, unless deflation collapses the world monetary system, and all paper becomes suspect. If that happens, men will grab for gold. But then there's the inflationary scenario. If world business fizzles, the various nations will probably opt for another round of re-flation which is a polite way of saying "more inflation." In that case, paper currencies will depreciate even faster, and men will protect themselves with gold.

At any rate as I see it, the rate of inflation is now dropping off, but gold has been rising. Gold has been rising out of **fear**, and we old-time observers are wondering whether this is a real gold move or a fake-out. My own feeling is that this is not THE gold move. But then, I've been wrong before.

Now here's an interesting item. My chart below shows the relative strength of gold bullion against gold shares. For three years the trend has been in favor of gold bullion over the shares, but now we see a break in the trendline, and this means that the shares are beginning to outperform the metal.

I thought this change was interesting enough to bring to the attention of subscribers. Remember, this does not mean that gold or gold shares are going up. It just means that for the first time in three years, gold-philes prefer the shares to the metal itself.

LATE NOTES: Looking over the whole situation, it is clear that the coming bottom isn't going to be a little "sissy" affair, a minor "poof" on the downside. No, as I've been saying for quite some time, the coming bottom is going to be an important one, something to underscore in the historical chartbooks.

As a rule, the longer a market decline continues and the more elusive the bottom, the more certain we can be that when the bottom finally does come it's going to be a "lulu." As I noted earlier, the current atmosphere and the sentiment is turning darker and darker. The September 27 *Wall Street Journal* headlined its front page article, "Take Your Pick. An Easing of Inflation–or More Inflation–Seen Hurting Stocks." You see, any way we turn stocks are bound to be a terrible investment, and there's no light, absolutely no light at the end of the tunnel! The only thing to do is to forget that common stocks ever existed.

I'll say it again, (1) I expect sentiment to turn black, jet black during the next few months. (2) If stocks are to mount a major advance somewhere ahead, it is an absolute prerequisite that there be massive buying power on the sidelines. How does the market put massive buying power on the sidelines? By scaring just about everyone to death, getting them **out of their stocks**, getting them in cash and on the sidelines. And it's axiomatic that to scare everyone to death, you need (1) a slump in stock prices, (2) bad news turning to frightful news, (3) a consensus that a bear market is on, (4) an event that serves to scare the last potential stockholders out–at or near the bottom.

Someone asked me what I thought could precipitate the final slide to over-sold. I said that it could well be an *unexpected news event*. What kind of news event? I have no idea. In 1957 it was the shock of the Russian "Sputnik." Today it could be–who knows, the Arabs buying Los Angeles, General Motors switching their production to Mopeds, MacDonald's going vegetarian, I just don't know, but I do think we could get a frightening news event that would precipitate the decline to the final bottom.

As I wind up this Letter, I realize that the month of September is about over and the bottom still lies somewhere ahead. I continue to hope that October will be the bottom. We'll see.

I've slated the next mailing for **October 14**. We have a holiday (Columbus Day) coming up, so I'm going to stretch two weeks between Letters. If anything unexpected comes up, unexpected and so important I can't hold off, I'll send the next Letter out earlier. But expect the next mailing out October 14.